LIBRARY
SUPREME COURT, U. S.

Office-Supreme Court, U.S.
FILED
OCT 26 1964
JOHN F. DAVIS, CLERK

Supreme Court of the United States.

OCTOBER TERM, 1964.

No. 620

REAL ESTATE INVESTMENT TRUST OF AMERICA ET AL.,
Petitioners,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

HENRY HIXON MEYER,
53 State Street,
Boston, Massachusetts 02109,
CHARLES D. POST,
84 State Street,
Boston, Massachusetts 02109.
Counsel for Petitioners.

Of Counsel:
WALTER G. VAN DORN,
RACKEMANN, SAWYER & BREWSTER,
53 State Street,
Boston, Massachusetts 02109,
JOSHUA M. BERMAN,
GOODWIN, PROCTER & HOAR,
84 State Street,
Boston, Massachusetts 02109.

ALDISON C. GETCHELL & SON, INC., LAW PRINTERS, BOSTON.

Table of Contents.

Opinions below	1
Jurisdiction	2
Question presented	2
Statute involved	2
Statement of the case	2
Reasons for the allowance of the writ	3
Appendix A	11
Opinion of the United States Court of Appeals	11
Judgment	19
Opinion of the Tax Court of the United States	20
Appendix B	27
Statutes involved	27
Appendix C	29
Conflicting opinions	29

Table of Authorities Cited.

CASES.

Caulkins, George Peck, 1 T.C. 656	8
C. I. R. v. Caulkins, 144 F. 2d 482	4
C. I. R. v. Morgan, 272 F. 2d 936	8n.
Dixon v. United States, 333 F. 2d 1016	5, 7, 8n.
Lubin v. C. I. R., 335 F. 2d 209	3, 5, 6, 7
Old Colony Railroad Co. v. C. I. R., 284 U.S. 552	6n.
Opinion of the U.S. Circuit Court of Appeals, 334 F. 2d 986	1, 5n.
Pattiz v. United States, 311 F. 2d 947	8n.

Rosen v. United States, 288 F. 2d 658 8n.
United States v. Harrison, 304 F. 2d 835 8n.
United States v. Midland-Ross Corporation, F. 2d
(July 29, 1964) 3, 4, 5, 7, 8n.

STATUTES, ETC.

Internal Revenue Code of 1954, 26 U.S.C.
§ 1221 2
§ 1222(3) 2
§ 1232 8n.
26 U.S.C. §§ 6213, 6214, 7442, 7482 3n.
28 U.S.C. § 1254(1) 2

Supreme Court of the United States.

OCTOBER TERM, 1964.

No.

REAL ESTATE INVESTMENT TRUST OF AMERICA ET AL.,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the First Circuit entered in the above-entitled case on July 28, 1964.[1]

Opinions Below.

The opinion of the Court of Appeals is reported at 334 F. 2d 986, and is set forth in Appendix A hereto, *infra,*

[1] The petitioners are Real Estate Investment Trust of America, a trust organized under the laws of the Commonwealth of Massachusetts, and its seven trustees, O. Kelley Anderson, John H. Gardiner, Charles Segal, Philip H. Theopold, Francis C Welch, Robert S. Fifield and Henri Bourneuf. All the petitioners and predecessor trusts and trustees are hereinafter collectively referred to as petitioner.

p. 11. The opinion of the Tax Court of the United States is reported at 40 T.C. 921 (1963), and is reprinted in Appendix A hereto, *infra*, p. 20.

Jurisdiction.

The judgment of the Court of Appeals was entered on July 28, 1964 (R. 132). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Question Presented.

Whether gain realized on the sale of a debt obligation previously acquired at a discount is taxable as ordinary income or as capital gain.

Statute Involved.

The statutory provisions involved are sections 1221 and 1222(3) of the Internal Revenue Code of 1954, 26 U.S.C. §§ 1221, 1222(3), set forth in Appendix B hereto, *infra*, p. 27.

Statement of the Case.

In 1948 the petitioner participated in the refinancing of a financially distressed debtor. The debtor, a real-estate trust owning an office building in downtown Boston, was in default to an institutional lender for more than $4 million on notes secured by first mortgages on its real and personal properties. Under threat of foreclosure, the following arrangement was entered into: (1) petitioner paid $500,000

and agreed to pay an additional $200,000 to the lender; (2) the lender reduced the amount of the debtor's obligation to it by more than $1 million, to $3 million; and (3) the debtor issued to petitioner its new note for $1 million secured by second mortgages on the debtor's properties.

The new note bore interest of $40,000 per annum, payable quarterly, representing an effective rate of interest of 8% per annum on the amount paid by petitioner. The interest was paid when due and was taxable when received as ordinary income. After several extensions of its maturity date, the note was sold by petitioner in 1958 to a third person for $270,000 more than its unrecovered cost. The note was a capital asset in the hands of petitioner. Petitioner reported the $270,000 gain on the sale of the note for federal income tax purposes as a long-term capital gain.

The Commissioner of Internal Revenue determined that the $270,000 gain realized was taxable as ordinary income. The Tax Court upheld the Commissioner;[2] the Court of Appeals affirmed.[3]

Reasons for the Allowance of the Writ.

1. The decision of the court below is in direct conflict with the decision of the United States Court of Appeals for the Sixth Circuit in *United States* v. *Midland-Ross Corporation*, F. 2d (July 29, 1964), reprinted in Appendix C hereto, *infra*, p. 29, and with the decision of the United States Court of Appeals for the Second Circuit in *Lubin* v. *C. I. R.*, 335 F. 2d 209 (July 27, 1964), reprinted in Appendix C hereto, *infra*, p. 49.

---

[2] The jurisdiction of the Tax Court of the United States was based on 26 U.S.C. §§ 6213, 6214 and 7442.

[3] The jurisdiction of the United States Court of Appeals for the First Circuit was based on 26 U.S.C. § 7482.

Each of the three Circuit Courts dealt with the question whether gain realized on the sale of a debt obligation previously acquired upon original issue at a discount is taxable as ordinary income or as capital gain. The First Circuit below held that such gain is taxable as ordinary income. The Sixth Circuit, reaffirming its earlier decision in *C. I. R.* v. *Caulkins*, 144 F. 2d 482 (1944), held that it is taxable as capital gain. The Second Circuit held that the gain may be taxable as ordinary income or as capital gain depending upon the facts of the particular case.

The basis for the Sixth Circuit's view is that where a debt obligation, such as a bond or note, is a capital asset,[4] gain on the sale of such an obligation falls within the statutory definition of capital gain.

The reasoning underlying the decision of the court below and other decisions in conflict with *Caulkins* and *Midland-Ross* is that, where in a loan transaction a borrower undertakes to pay a principal sum that is greater than the amount it has received, the excess of the principal sum over the amount received (*i.e.*, the original issue discount) represents compensation for the use of the money borrowed during the term of the loan. When, upon sale of the obligation, the holder realizes an amount (over and above his cost) equal to all or a portion of this excess, this amount is, under these decisions, held to be taxable as interest income even though it is an amount that is realized upon the sale of a capital asset.

The First Circuit in this case in effect held that, since original issue discount "often" represents compensation

[4] Throughout this petition it is assumed, as in fact it was in the instant case, that the debt obligation sold was a capital asset in the hands of the seller. In some cases, such as those where the seller deals in the purchase and sale of debt obligations in the ordinary course of his business, a debt obligation is not considered to be a capital asset; gain on the sale of such an obligation is always taxable as ordinary income.

for the use of money borrowed, gain on the sale of an original issue discount obligation is, as a matter of law, taxable as ordinary income. Whether, on the one hand, the obligation bears a fair rate of interest apart from the discount, or whether, on the other hand, the discount is an obvious substitute for interest was said to be "of little significance."[5]

This rigid view was urged upon the United States Court of Appeals for the Second Circuit and rejected in *Lubin*. The Second Circuit, like the First Circuit, is in direct conflict with the Sixth Circuit's decision in *Midland-Ross*. The Second Circuit has held that gain realized on the sale of an original issue discount obligation is taxable as ordinary income where the discount represents an interest equivalent. *Dixon* v. *United States*, 333 F. 2d 1016 (June 19, 1964). However, the Second Circuit and the First Circuit are in conflict with one another on whether gain realized on the sale of a debt obligation acquired upon original issue at a discount is *always* to be treated as interest income and taxable as ordinary income. The First Circuit held that such is the rule as a matter of law. The Second Circuit in *Lubin* reversed a memorandum decision of the Tax Court, T.C. Memo. 1963-292, and held that the gain may be taxable as ordinary income or as capital gain depending upon the facts of the particular case—that the transaction giving rise to the obligation must be "reduced to its essentials" in order to determine whether the discount in substance represents compensation for the use of

[5] "In an attempt to distinguish the cases repudiating *Caulkins*, petitioner refers to the fact that the discount in those cases was an obvious substitute for interest while here the obligation bore a substantial, fair, independent rate of interest. That fact is of little significance, however, since original issue discount is often in the nature of *additional* interest which accrues over the life of the instrument and is payable at maturity of the principal obligation." 334 F. 2d 986, 990, *infra*, p. 17.

money borrowed or whether it represents a potential speculative profit.

> "The Commissioner would have us rule that anything above face value paid on notes by an obligor must, as a matter of law, be regarded as interest, no matter what the substance might be of the underlying transaction which has given rise to the obligations. . . .
>
> ". . . As the Code does not require a profit realized in this form to be treated as interest, and as the evidence relating to the substance of the transaction afforded no basis upon which the Tax Court could have concluded that these profits were interest payments, we hold that § 1232(a)(1) should be applied in accordance with its terms so that petitioners will be taxed at capital gains rates." 335 F. 2d 209, 213, *infra*, pp. 56, 58.

This Court has defined interest within the meaning of the revenue laws as follows:

> ". . . '[I]nterest' means what is usually called interest by those who pay and those who receive the amount so denominated in bond and coupon . . . the words of the statute . . . do not refer to some esoteric concept derived from subtle and theoretic analysis."[6]

When the transaction in the instant case is reduced to its essentials, it becomes clear that the discount involved did not represent an interest equivalent. Immediately before the 1948 refinancing, the debtor was in default to an institutional lender for more than $4 million on notes

[6] *Old Colony Railroad Co.* v. *C. I. R.*, 284 U.S. 552 (1932), at p. 561.

secured by mortgages on its real and personal properties. R. 28. The lender insisted on a substantial reduction in the debtor's obligation to it. R. 28. The refinancing arrangement was entered into under threat of foreclosure. R. 28, 39.

The transaction giving rise to the new obligation was in effect an assignment by the lender to petitioner at a discount of the portion of the lender's claim against the debtor in excess of $3 million. The new $1 million note issued to petitioner was issued in consideration of the discharge of a portion of an antecedent debt owed by the debtor to the lender. R. 29. Upon issuance of the new note, the debtor received its full principal amount (in fact, more) by the reduction of its indebtedness to the lender by more than $1 million. R. 29, 30. The new note issued to petitioner bore interest of $40,000 per annum, payable quarterly, representing an effective rate of interest of 8% per annum on the amount paid by petitioner. R. 29. On these facts it is clear that the discount represented not an interest equivalent as it did in *Dixon*, but rather a potential profit as in *Lubin*.

The Court is asked to resolve the conflict among the Circuits either in favor of the view of the Sixth Circuit that gain on the sale of a debt obligation acquired at a discount is taxable as capital gain, or in favor of the view of the Second Circuit that gain on the sale of such an obligation may be taxable as ordinary income or as capital gain depending upon all the facts and circumstances of the particular case.

Petitioner does not know whether the United States will petition for a writ of certiorari to review the Sixth Circuit's decision in *Midland-Ross*, or whether the United States will seek certiorari to review the Second Circuit's decision in *Lubin*. The taxpayer has sought certiorari to review the Second Circuit's decision in *Dixon*. Docket No. 486.

2. The questions presented in this case are of substantial importance in the administration of the internal revenue laws.

The federal income tax treatment of gain realized on the sale of original issue discount obligations has long been unsettled. In 1943 the Tax Court in *Caulkins* held that gain realized on the sale of such obligations was taxable as capital gain.[7] In 1944 the Commissioner of Internal Revenue announced that he acquiesced in this decision.[8] It was not until ten years later, in 1955, that the Commissioner reversed his position and withdrew his acquiescence.[9] Since then this issue has been litigated in five Circuit Courts of Appeals[10] and the Court of Claims,[11] resulting in the conflict among the Circuits herein noted.

The reported cases suggest that a great many debt obligations involving substantial sums were issued in the form of original issue discount obligations during the ten-year period when the Commissioner's published acquiescence in *Caulkins* was outstanding. Undoubtedly, a great many of these obligations have yet to be disposed of.[12]

---

[7] *George Peck Caulkins*, 1 T.C. 656 (1943).

[8] C.B. 1944, p. 5.

[9] C.B. 1955-1, p. 7.

[10] The First Circuit; Second Circuit, *Dixon, supra;* Third Circuit, *Rosen* v. *United States*, 288 F. 2d 658 (1961); Fifth Circuit, *United States* v. *Harrison*, 304 F. 2d 835 (1962); Sixth Circuit, *Midland-Ross, supra; and Ninth Circuit, C. I. R.* v. *Morgan*, 272 F. 2d 936 (1959).

[11] *Pattiz* v. *United States*, 311 F. 2d 947 (1963).

[12] Section 1232 of the Internal Revenue Code of 1954 provides a statutory rule with respect to the sale or retirement of debt obligations of corporations, governments or political subdivisions thereof issued after December 31, 1954. The new statutory rule does not apply to the sale or retirement of debt obligations issued during the ten-year period 1944 to 1954, while the Commissioner's published acquiescence in *Caulkins* was outstanding. Nor does the new statutory rule apply to debt obligations of individuals, partnerships and other non-corporate persons.

The Commissioner has given no relief to taxpayers who acted in reliance on his announced position on this issue.[13] This itself raises the question whether the courts should sanction such a departure from the fair administration of the revenue laws. In any event, it is all the more reason why the conflict among the Circuits herein noted ought to be resolved in this Court.

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

HENRY HIXON MEYER,

CHARLES D. POST,

Counsel for Petitioners.

---

[13] The debt obligation sold in this case was acquired by petitioner in 1948, during the ten-year period of the Commissioner's announced acquiescence in *Caulkins*.

Appendix A.

Opinion of the United States Court of Appeals.

[334 F. (2d) 986 (1st Cir., 1964).]

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No. 6288.

REAL ESTATE INVESTMENT TRUST
OF AMERICA ET AL.,
PETITIONERS,
v.
COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

ON PETITION FOR REVIEW OF THE DECISION OF THE
TAX COURT OF THE UNITED STATES
[40 T.C. 921]

Before WOODBURY, *Chief Judge,* and HARTIGAN and ALDRICH, *Circuit Judges.*

Edward C. Thayer and *Walter G. Van Dorn*, with whom *Rackemann, Sawyer & Brewster* was on brief, for petitioners.

Carolyn R. Just, Attorney, Department of Justice, with whom *Louis F. Oberdorfer,* Assistant Attorney General, and *Lee A. Jackson* and *Joseph Kovner,* Attorneys, Department of Justice, were on brief, for respondent.

OPINION OF THE COURT.

July 28, 1964.

HARTIGAN, *Circuit Judge.* This is a petition for review of a decision of the Tax Court entered on October 21, 1963.

The petitioners are Real Estate Investment Trust of America and its seven trustees but for purposes of this appeal only the Trust will be referred to, and that as petitioner.

The facts have been stipulated. In 1948 Boston Chamber of Commerce Realty Trust (hereinafter Realty Trust) was in arrears to the Prudential Insurance Company in the amount of $3,500,000 unpaid principal borrowed between 1922 and 1925 to finance Realty Trust's erection of a downtown office building. The loans were represented by two Realty Trust notes secured by a first and second mortgage on the property, a first mortgage on certain personal property within the office building and an assignment of all rents from the building. There was also owing to Prudential by Realty Trust over $500,000 unpaid interest on the two notes.

In an attempt to achieve a substantial reduction in Realty Trust's debt, on May 12, 1948 Realty Trust, Prudential and Boston Real Estate (hereinafter Boston) entered into a refinancing arrangement whereby Realty Trust agreed to execute and deliver to Prudential an extension agreement acknowledging that the principal then owed to Prudential was $3,000,000. Realty Trust also agreed to execute and deliver to Boston a note dated May 12, 1948 in the face amount of $1,000,000 at 4 percent interest to mature on September 26, 1952 and secured by a second mortgage on the real estate, a second mortgage on the personal property within the building and a secondary assignment of the office building's rents. On its part, Boston agreed to pay, and Prudential agreed to accept, $500,000 and $200,000, without interest, on September 26, 1952 as substitution for and in satisfaction of that portion of Realty Trust's overdue debt (both principal and interest) in excess of $3,000,000. Prudential discharged its second mortgage on the real estate.

The $1,000,000 note had no interest coupons nor was it at any time in registered form. It carried with it a provision for prepayment of the face amount in whole or in part at any time. The note was acquired by petitioner in November of 1955 when Boston and several other trusts were, through the medium of a tax free exchange, consolidated into petitioner. The note was assigned to petitioner which succeeded to and acquired Boston's basis in the note.

On September 26, 1952 by agreement between Prudential, Realty Trust and Boston the maturity date of the note was extended to September 26, 1957. A further extension of the maturity date to September 26, 1959 with interest increased to 6 percent, was agreed to by Realty Trust, Prudential and petitioner upon the arrival of the September 1957 date.

On September 30, 1958, Realty Trust entered into an agreement for the sale of its land and office building to the Federal-Franklin Trust subject to the mortgages held by Prudential and petitioner and subject to the entry of a decree by the Suffolk County Probate Court approving such sale. Following the court's approval the sale was completed and the property actually conveyed on December 30, 1958 for $559,000 subject to the mortgages.

On November 25, 1958, the petitioner sold the note of May 12, 1948, which at this time had an unpaid principal balance of $749,053.41, for $719,053.41 to Fifty Associates, a Massachusetts corporation. The sale was a bona fide transaction. As of the date of the sale Realty Trust had paid to petitioner and its predecessor $250,946.59 of principal on the note thereby reducing petitioner's basis in the note to $449,053.41. In addition, Realty Trust had paid the interest specified in the note, as amended. Petitioner received on

the sale of the note $270,000 in excess of its basis in the note. The note was a capital asset in the hands of petitioner and on the date of its sale had been held by the petitioner for more than six months.

A few days prior to the completion of the sale of the land and building, the prospective purchaser, Federal-Franklin Trust, requested Fifty Associates, the purchaser of the note from petitioner, to accept payment thereon. Fifty Associates agreed and on December 30, 1958, the note was paid by Federal-Franklin Trust.

On its income tax return for the taxable year ended May 31, 1959, petitioner reported the amount received in excess of its basis in the note ($270,000) as long-term capital gain. The respondent determined that the gain realized by petitioner on the sale of the note was taxable as ordinary income. In its decision the Tax Court held that the gain realized from the sale was, in fact, interest in the form of an original issue discount and taxable as ordinary income. A deficiency was assessed in petitioner's income tax in the amount of $72,900.

Petitioner relies on the case of *Commissioner of Internal Revenue* v. *Caulkins*, 144 F. 2d 482 (6th Cir. 1944) to support its contention that original issue discount is not ordinary income in the nature of interest but is instead capital gain. It argues that since the note constituted a capital asset held for more than six months a gain resulting from its bona fide sale is governed by the tax provisions of section 1222(3) of the Int. Rev. Code of 1954.[1]

---

[1] SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle—

(3) Long-term Capital Gain.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months. . . .

In *Caulkins,* the taxpayer, pursuant to a contract with Investors Syndicate, received upon retirement of the "Accumulative Installment Certificate" an amount above the aggregate payments made by him. The Sixth Circuit found the excess amount to constitute interest and held the interest taxable at capital rates. The court read the then applicable statute, section 117(f) of the Int. Rev. Code of 1939, as containing a special definition of capital gains, applicable to all amounts received upon retirement of a corporate bond, including interest. This decision, however, has not gone unchallenged and attempts by later taxpayers to rely on it in seeking to have original issue discount treated as capital gain have been largely unsuccessful. The courts have either limited *Caulkins* to its facts, *e.g., Warner A. Shattuck,* 25 T.C. 416 (1955); *F. Rodney Paine,* 23 T.C. 391 (1954), rev'd on other grounds, 236 F.2d 398 (8th Cir. 1956), or have repudiated it outright. *E.g., Pattiz* v. *United States,* 311 F. 2d 947 (Ct. of Cl. 1963); *United States* v. *Harrison,* 304 F. 2d 835 (5th Cir. 1962), cert. denied, 372 U.S. 934 (1963); *Rosen* v. *United States,* 288 F. 2d 658 (3rd Cir. 1961); *C.I.R.* v. *Morgan,* 272 F. 2d 936 (9th Cir. 1959); but see *Midland-Ross Corporation* v. *United States,* 214 F. Supp. 631 (N.D. Ohio 1963). In view of the reason advanced by petitioner for its reliance on *Caulkins,*[2] the decision of the court in *Dixon* v. *United States,* 224 F. Supp. 358, 361 (1963), aff'd (2d Cir. June 19, 1964), is especially pertinent:

---

[2] Petitioner finds *Caulkins* "in point because it dealt with a taxable gain on a disposition (whether on redemption or on sale) of a capital asset. And the decision that the gain on such a disposition, whether on redemption or (as in our case) by sale, was taxable as a capital gain is conclusive authority on a sale under the plain wording of Section 1222(3) as in our case."

> "The [Tax Court and Sixth Circuit] in Caulkins failed to realize that the gain realized from the deemed sale of a capital asset which has appreciated in value is capital gain, whereas, gain realized by income from the capital asset is ordinary income. The court, in other words, considered both the capital asset and the increment by way of interest or discount together and considered the combined amount as a capital gain."

In light of the above cited decisions, we think it obvious that *Caulkins* cannot be considered as the weight of authority as to the tax treatment of original issue discount. 3B Mertens, Law of Federal Income Taxation § 22.40. Rather, that case seems to have been an exception to the general rule that amounts received from original issue discounts are treated as ordinary income. See *Jaglom* v. *C.I.R.*, 303 F.2d 847, 849 (2d Cir. 1962). Original issue discount is a form of interest or compensation for the use of money. See *American Smelting & Refining Co.* v. *United States*, 130 F.2d 883, 885 (3rd Cir. 1942). As such, it is taxable as ordinary income under Section 61(a) of the 1954 Code.[3] Ordinary income cannot be converted into capital gain by any sale or exchange of the right to the income, either separately or in conjunction with the property producing the income. *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260 (1958); *Hort* v. *Commissioner*, 313 U.S. 28

---

[3] "SEC. 61 GROSS INCOME DEFINED.

(a) General Definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

. . .

(4) Interest;

. . . "

(1941); *Tunnell* v. *United States*, 259 F.2d 916 (3rd Cir. 1958).

In an attempt to distinguish the cases repudiating *Caulkins*, petitioner refers to the fact that the discount in those cases was an obvious substitute for interest while here the obligation bore a substantial, fair, independent rate of interest. That fact is of little significance, however, since original issue discount is often in the nature of *additional* interest which accrues over the life of the instrument and is payable at maturity of the principal obligation. *American Smelting & Refining Co.* v. *United States, supra*, at 885 and authorities cited therein.[4]

As an alternative argument, petitioner contends that no original issue discount at all was involved but that the difference between the $1,000,000 face value of the note and the $700,000 which Boston paid for it was "market discount for the embarking of funds in a hazardous operation." As pointed out by the Tax Court, evidence in the record does not establish that the discount reflected anything other than compensation for the use of money loaned. The fact that the note was acquired in a three party refinancing arrangement and that the money was paid directly to Prudential rather than to Realty Trust does not mean that petitioner's predecessor did not make a loan to the maker of the note. It was a borrower-lender arrangement with the note evidencing an ordinary type of loan, secured by mortgages on real and personal property as well as by an assignment of rents.

---

[4] The obligation in *United States* v. *Harrison, supra*, was a second mortgage note which carried both a stated interest rate and an original discount. See also *V. David Leavin*, 37 T.C. 767 (1962) where the debentures in issue carried stated interest rates and original discounts.

In his deficiency notice the Commissioner stated that the gain was taxable as ordinary income but did not state that the reason for this was that the gain constituted interest. The Tax Court assumed such a determination had been made and gave it the benefit of a presumption, placing upon petitioner the burden of showing "that its realized gain is attributable to something other than interest." We do not, however, believe that petitioner was unfairly prejudiced by this. The case was tried on the basis of a stipulation which included the statement that the parties were not in agreement as to whether the amount received on the sale of the note should be characterized "as capital gain," as ordinary income, as interest or otherwise. . . . ," thus showing petitioner's awareness of the Commissioner's position at the time the case was heard. In addition, petitioner does not claim the benefit of any new evidence which would strengthen its position were the case returned to the Tax Court. *Hay* v. *Commissioner of Internal Revenue,* 145 F.2d 1000, 1007-1008 (4th Cir. 1944). As we have already stated, based upon the record and stipulation before us, the court reached the correct result.

Judgment will be entered affirming the decision of the Tax Court.

Appendix A—Judgment of Court of Appeals

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No. 6288.

REAL ESTATE INVESTMENT TRUST OF AMERICA ET AL.,
PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

Judgment

July 28, 1964.

This cause came on to be heard on petition for review of a decision of the Tax Court of the United States, and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The decision of the Tax Court is affirmed.

By the Court:

/s/ ROGER A. STINCHFIELD
Clerk.

Opinion of the Tax Court of the United States.

(40 T.C. 921, 1963.)

REAL ESTATE INVESTMENT TRUST OF AMERICA, O. KELLEY ANDERSON, JOHN H. GARDINER, CHARLES SEGAL, PHILIP H. THEOPOLD, FRANCIS C. WELCH, ROBERT S. FIFIELD AND HENRI BOURNEUF, TRUSTEES, PETITIONER, *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 91582. Filed September 4, 1963.

Petitioner's predecessor in interest acquired an interest-bearing $1 million promissory note at a cost of $700,000. Prior to maturity petitioner sold the note and realized a gain of $270,000. *Held*, the gain so realized was, in fact, interest and was taxable as ordinary income notwithstanding the fact that the transaction resulting in the realization of such gain was a sale.

Edward C. Thayer, for the petitioner.
J. Frost Walker, Jr., for the respondent.

OPINION

FAY, *Judge:* Respondent determined deficiencies in petitioner's income tax for the taxable years ended May 31, 1959, and May 31, 1960, in the amounts of $120,707.29 and $26,325.38, respectively. The only issue[1] remaining for decision is whether all or a part of the gain realized upon the sale of a promissory note which was originally acquired at a discount by the seller constitutes interest taxable as ordinary income.

[1] In its petition to this Court, petitioner did not place in issue respondent's adjustments for the fiscal year ended May 31, 1960, and with the exception of the above-stated issue did not contest respondent's other adjustments for the taxable year ended May 31, 1959.

All of the facts have been stipulated and are found accordingly.

Real Estate Investment Trust of America (hereinafter referred to as petitioner) was created in 1955 by the consolidation of the Boston Real Estate Trust (hereinafter referred to as Boston) and several other trusts. Boston was organized in 1886 under the laws of Massachusetts and until the time of its consolidation with other trusts into the petitioner was engaged in the ownership and management of improved business real estate in Boston, Mass., and elsewhere.

Petitioner at all times has kept its records and filed its income tax returns on a cash receipts and disbursements fiscal year basis ending May 31. For the taxable year ending May 31, 1959, petitioner filed its Federal income tax return (Form 1120) with the district director of internal revenue at Boston, Mass.

During the years between 1922 and 1925 the Boston Chamber of Commerce Realty Trust (hereinafter referred to as Realty Trust) erected an office building in Boston, Mass. In addition to the funds raised by the sale of its capital stock, Realty Trust made two borrowings from the Prudential Insurance Co. of America (hereinafter referred to as Prudential). The first borrowing in the amount of $3,600,000 was evidenced by a note dated September 26, 1922, and was secured by a first mortgage on the property. The second borrowing in the amount of $400,000 was evidenced by a note dated June 11, 1925, and was secured by a second mortgage on the property. In 1937 Realty Trust executed and delivered to Prudential a first mortgage on certain personal property contained in the office building as further security for the two notes. In 1940 Realty Trust executed and delivered to Prudential an assignment of all

rents from the office building as further security for the two notes.

As of May 12, 1948, there was overdue and unpaid the principal sum of $3,500,000 and in excess of $500,000 of unpaid interest on the two notes. As a result, Prudential insisted upon a substantial reduction in such indebtedness.

On May 12, 1948, Boston, together with Prudential and Realty Trust, entered into a refinancing arrangement. The gist of the arrangement was (1) that Realty Trust was to execute and deliver to Prudential an extension agreement which acknowledged that the principal sum then owed to Prudential was $3 million; (2) that Realty Trust as maker was to execute and deliver to Boston as payee a note dated May 12, 1948, in the face amount of $1 million which was to bear interest of 4 percent per annum and was to mature on September 26, 1952; (3) that Boston was to pay to Prudential $500,000 and to deliver to Prudential an agreement to pay an additional $200,000 without interest on September 26, 1962; (4) that Prudential was to accept the payment of $500,000 and the agreement of Boston to pay $200,000 at a later date in substitution for and satisfaction of that portion of the indebtedness (both principal and interest) then due by Realty Trust to Prudential in excess of $3 million; (5) that Prudential was to discharge its second mortgage of real estate dated June 11, 1925; (6) that as security for the $1 million note Boston was to receive a second mortgage on the real estate, a second mortgage on the personal property contained in the office building, and a secondary assignment of the rents from the office building.

The $1 million note dated May 12, 1948 (hereinafter referred to as the Boston note), and delivered to Boston pursuant to the above arrangements at no time had interest coupons and was at no time in registered form.

By the maturity date of the Boston note, i.e., September 26, 1952, Realty Trust had paid to Boston $113,198.49 of principal, thereby reducing Boston's basis in such note from $700,000[2] to $586,801.51. In addition, as of September 26, 1952, Realty Trust had paid to Boston the 4 percent interest specified in said note.

On September 26, 1952, an agreement was entered into among Realty Trust, Boston, and Prudential extending the maturity date of the Boston note to September 26, 1957.

During the month of November 1955 Boston and several other trusts were, through the medium of a tax-free exchange and reorganization, consolidated into the petitioner. By virtue of such reorganization, the Boston note was transferred to petitioner and petitioner succeeded to and acquired Boston's basis in the note.

By the extended maturity date of September 26, 1957, Realty Trust had paid to petitioner and its predecessor, Boston, $223,816 of principal on the Boston note, thereby reducing petitioner's basis in such note to $476,184. In addition, Realty Trust had made the interest payments specified in the note.

On September 26, 1957, an agreement was entered into among Realty Trust, Prudential, and petitioner further extending the maturity date of the note to September 26, 1959, and increasing the interest from 4 percent to 6 percent.

On September 30, 1958, Realty Trust entered into an agreement for the sale of its land and office building to the Federal-Franklin Trust subject to the mortgages held by Prudential and petitioner and subject to the entry of a decree by the Suffolk County Probate Court approving such

[2] Cash payment of $500,000 plus indebtedness of $200,000.

sale. Following a hearing before the Probate Court on November 5, 1958, a sales price of $559,000 for the equity subject to the two mortgages was authorized. The sale was completed and the property actually conveyed on December 30, 1958.

On November 25, 1958, the petitioner sold the Boston note, which at this time had an unpaid principal balance of $749,053.41, for $719,053.41 to Fifty Associates, a Massachusetts corporation. The sale was a bona fide transaction. As of the date of the sale Realty Trust had paid to petitioner and its predecessor $250,946.59 of principal on the note thereby reducing petitioner's basis in the note to $449,053.41. In addition, Realty Trust had paid the interest specified in the Boston note, as amended. Petitioner received on the sale of the Boston note $270,000 in excess of its basis in the note. The Boston note was a capital asset in the hands of petitioner and on the date of its sale had been held by the petitioner for more than 6 months.

A few days prior to the completion of the sale of the land and building, the prospective purchaser, Federal-Franklin Trust, requested Fifty Associates, the purchaser of the Boston note from petitioner, to accept payment of the Boston note. Fifty Associates agreed to accept payment and on December 30, 1958, the Boston note was paid by Federal-Franklin Trust.

On its income tax return for the taxable year ended May 31, 1959, petitioner reported the amount received in excess of its basis in the Boston note ($270,000) as long-term capital gain. The respondent determined that the gain realized by petitioner on the sale of the Boston note was taxable as ordinary income.

The only issue presented for our consideration is whether the gain realized by petitioner upon the sale of the Boston

note is taxable at ordinary income or capital gains rates. The respondent determined that the difference between the petitioner's basis in the Boston note and the face value of such note (adjusted to the price at which it was sold just before maturity) was interest in the form of an original issue discount. Such being the case, the respondent contends that the gain is taxable as ordinary income.

Petitioner contends that since the Boston note was a capital asset held for more than 6 months and since the sale was a bona fide transaction the taxability of the realized gain is governed by the provisions of section 1222(3) of the Internal Revenue Code of 1954.[3]

It is now the generally accepted rule that a right to receive ordinary income produced by a capital asset is not transmuted into a capital asset by the sale or exchange of the capital asset together with the right to receive the ordinary income. *Tunnell* v. *United States*, 259 F. 2d 916 (C.A. 3, 1958); *Rosen* v. *United States*, 288 F. 2d 658 (C.A. 3, 1961); *United States* v. *Harrison*, 304 F. 2d 835 (C.A. 5, 1962); *Fisher* v. *Commissioner*, 209 F. 2d 513 (C.A. 6, 1954), affirming 19 T.C. 384 (1952), certiorari denied 347 U.S. 1014 (1954); *Jaglon* v. *Commissioner*, 303 F. 2d 847 (C.A. 2, 1962), affirming 36 T.C. 126 (1961); *Commissioner* v. *Morgan*, 272 F. 2d 936 (C.A. 9, 1959), reversing 30 T.C. 881 (1958); *Richard B. Gibbons*, 37 T.C. 569 (1961). Consequently, petitioner's reliance upon section 1222(3) of the 1954 Code is misplaced if, in fact, any part of the gain real-

[3] SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle—

(3) LONG-TERM CAPITAL GAIN.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months. * * *

ized upon the sale of the Boston note is attributable to a right to receive ordinary income. The respondent's determination is, of course, presumptively correct and the burden is upon the petitioner to show that its realized gain is attributable to something other than interest. *F. Rodney Paine,* 23 T.C. 391 (1954), reversed on other grounds 236 F. 2d 398 (C.A. 8, 1956).

The record discloses that the petitioner's predecessor acquired the Boston note ($1 million face value) at cost of $700,000, thereby receiving an original issue discount of $300,000. In the absence of evidence to the contrary, original issue discounts are usually treated as additional compensation for the use of the lender's money. *F. Rodney Paine, supra; L. Lee Stanton,* 34 T.C. 1 (1960); *Richard B. Gibbons, supra; Rosen* v. *United States, supra; United States* v. *Harrison, supra.* See also *American Smelting & Refining Co.* v. *United States,* 130 F. 2d 883, 885 (C.A. 3, 1942). Compensation for the use or forbearance of money is interest, *Deputy* v. *duPont,* 308 U.S. 488, 498 (1940); *Charles T. Fisher.* 19 T.C. 384 (1952), affd. 209 F. 2d 513 (C.A. 6, 1954), and includable in gross income under section 61(a) (4) of the 1954 Code. Since there is no evidence in the record to support a finding that the discount in this case reflected elements or factors having no relation to interest, the conclusion is inescapable that the gain realized by petitioner upon the sale of the Boston note was essentially compensation for the use of its money. Accordingly, respondent's determination with respect to this issue is sustained.

Decision will be entered under Rule 50.

Appendix B.

Statutes Involved.

INTERNAL REVENUE CODE OF 1954.

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, or similar property, held by—

(A) a taxpayer whose personal efforts created such property, or

(B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services ren-

dered or from the sale of property described in paragaph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle—

. . . . . .

(3) LONG-TERM CAPITAL GAIN.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

. . . . . .

Appendix C.

(Conflicting Opinions)

No. 15524

[F. (2d) , (6th Cir., 1964).]

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

MIDLAND-ROSS CORPORATION, *Plaintiff-Appellee,* v. UNITED STATES OF AMERICA, *Defendant-Appellant.*	ON APPEAL from the United States District Court, Northern District of Ohio, Eastern Division.

Decided July 29, 1964.

Before: WEICK, Chief Judge, CECIL, Circuit Judge, and MCALLISTER, Senior Circuit Judge.

PER CURIAM. This cause is before the Court on appeal from a judgment of the United States District Court for the Northern District of Ohio granting judgment in favor of the appellee, a taxpayer, against the United States, the appellant. The sole question presented on the appeal is whether original discount income received upon the sale of notes prior to their maturity is entitled to be treated as capital gains under Section 117(f) of the Internal Revenue Code of 1939.

Appendix C—Conflicting Opinions

Judge Kalbfleisch of the District Court wrote a comprehensive opinion in the case in which he followed the ruling of this Court in *Commissioner of Internal Revenue* v. *Caulkins,* 144 F. 2d 482. While some courts[1] have taken a contrary view on the issue presented we are of the opinion that the *Caulkins* case, controlling in our circuit, was correctly decided.

The pertinent facts are stated in the opinion of the District Court reported at *Midland-Ross Corp.* v. *United States,* 214 F. Supp. 631. We agree with the opinion of Judge Kalbfleisch and the judgment of the District Court is affirmed.

[214 F. Supp. 631 (N.D. Ohio, 1963).]

MIDLAND-ROSS CORPORATION, Plaintiff,

v.

UNITED STATES of America, Defendant.

Civ. A. No. 36611.

United States District Court
N. D. Ohio, E. D.
March 11, 1963.

KALBFLEISCH, District Judge.

This is a suit to recover income and excess profits taxes for the years 1952, 1953 and 1954. The taxpayer is the Midland-Ross Corporation, successor in interest to the Industrial Rayon Corporation. During the period in question,

---

[1] *Dixon* v. *United States,* — F. 2d —, C.A. 2; *Pattitz* v. *United States,* 311 F. 2d 947, Ct. Cl.; *United States* v. *Harrison,* 304 F. 2d 835, C.A. 5, cert. den., 372 U.S. 934; *Rosen* v. *United States,* 288 F. 2d 658, C.A. 3; *Commissioner* v. *Morgan,* 272 F. 2d 936, C.A. 9.

for the purpose of temporarily investing funds not then currently required for its operation, the taxpayer purchased thirteen notes, the face amounts of which varied from $500,000 to $2,000,000. These notes bore no interest, but rather were purchased at a discount by the taxpayer from the maker. Each of the notes was a time instrument.

Before maturity each note was sold to a financial institution at a price which was in excess of the price which had been paid to the maker but below the face amount.

The price paid by the taxpayer to the maker of each note was calculated by subtracting from the face amount a figure determined by multiplying the face amount by an agreed percentage, dividing the product by 360, and multiplying the result by the number of days from the date of such payment to the maturity of the note. The agreed percentage was determined on the basis of the consideration of several factors, including (1) the prevailing interest rates for notes of such duration made by borrowers with credit standings of the obligor, (2) the availability of such notes to prospective purchasers, and (3) the maker's need for cash funds. All of the notes were capital assets in the hands of the taxpayer and were sold by it in bona fide sales. In negotiating the sale price of the notes, the following factors were considered: (1) the face amounts of the obligations, (2) the credit rating of the obligor, (3) the period of time between the sale and the maturity of the notes, (4) the prevailing interest rates, and (5) the amount of cash funds available to the purchaser.

In this three-year period the taxpayer realized a total appreciation of more than $280,000 on these notes. It contended that this appreciation was a capital gain, while the Internal Revenue Service contended that it was regular income. The taxpayer paid taxes at the regular income rate, and is here seeking a refund.

Appendix C—Conflicting Opinions

The relevant sections of the Internal Revenue Code are: Section 117(a) (1) (2) and (4) and Section 111(a) of the 1939 Code, and their counterparts in the Code of 1954.

Section 117(a) (1) of the 1939 Code defines a capital asset as:

> "* * * property held by the taxpayer (whether or not connected with his trade or business), but does not include * * *
>
> "(D) an obligation of the United States or of any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue."

Subsections (2) and (4) of Section 117(a) provide that a capital gain is a gain from the sale of a capital asset, and Section 111(a) provides that the gain from the disposition of property is the "excess of the amount realized therefrom over the adjusted basis * * *."

Plaintiff stresses the fact that the language of the statute, especially of Section 117(a) (1) defining a capital asset, is broad and sweeping. It contends that because these notes were capital assets the gain realized thereon was a capital gain. It contends, further, that in view of Section 117(a) (1) (D), which specifically excludes certain types of discount paper from the category of capital assets, and in view of the failure to exclude such paper as these notes, the Congress clearly indicated its intention that the gain achieved on the sale of such notes constitutes capital gain under the maxim of *expressio unius est exclusio alterius.*

[1] The taxpayer's contention is a familiar enough general rule of statutory construction. However, various courts have read certain exceptions into this statute. They have held that, while it might appear that a literal construction of the statutory language would convert all but the specifically excluded gains into capital gains, the provisions must be construed in the light of their general purpose and the surrounding law. After so doing, these courts have read further exceptions into the statute, which have resulted in the exclusion from capital gains treatment of certain increments which a literal interpretation might indicate were capital gains. See, for example, Jaglom v. Commissioner, 303 F.2d 847 (2nd Cir., 1962); United States v. Harrison, 304 F.2d 835 (5th Cir., 1962). In view of the fact that these statutory sections have not been interpreted to include all of the transactions which the sweeping scope of their language might indicate were within their purview, the Court is constrained to hold that this argument is not dispositive of the case.

The Government contends that the realized increment was in fact interest paid for the use of money, and was therefore regular income to the taxpayer. It contends that this is but another instance for application of the well recognized rule that when a taxpayer combines the sale of a right to receive ordinary income with the sale of a capital asset the ordinary income is not converted into a capital gain by its sale in combination with the capital asset. Fisher v. Commissioner, 209 F.2d 513 (6th Cir., 1954), cert. den. 347 U.S. 1014, 74 S.Ct. 868, 98 L.Ed. 1136; Commissioner v. Morgan, 272 F.2d 936 (9th Cir., 1959); Rosen v. United States, 288 F.2d 658 (3rd Cir., 1961); United States v. Harrison, 304 F.2d 835 (5th Cir., 1962); and United States v. Langston, 308 F.2d 729 (5th Cir., 1962).

The taxpayer does not dispute the general validity of this proposition. Its principal contention, however, is that the rule is inapplicable on these facts because the increment, for purposes of taxation at least, was not interest. It fully admits that if these notes had borne interest at a stated rate, and if it had then sold such notes before maturity at an increase in price, the amount of such increase allocable to the proportion of the interest earned to the date of sale would have been regular income under the rule of Fisher v. Commissioner and the other cases cited, supra. However, it contends that a different result is achieved when, instead of the notes bearing interest at a fixed rate, they were originally sold at a discount. The taxpayer urges that there has been a continuous history of legislative, administrative and judicial interpretation since 1920 which has consistently held that original issue discount in the hands of a cash basis taxpayer is not income, and that the appreciation resulting therefrom is not taxed as regular income but, rather, as a capital gain.

[2] If it is true that historically the law has not considered such original issue discount as interest, but has removed it from the broad category of regular income and placed it within the specific classification of capital gain, then the increment in this case was not income and the general rule upon which the Government relies is inapplicable. The Court, therefore, must proceed to examine the treatment which such discount has traditionally received.

Commissioner v. Caulkins, 144 F.2d 482 (6th Cir., 1944) is the primary cornerstone upon which the taxpayer rests its contention that the increment here involved was not, for taxation purposes at least, compensation for the use of its money. In that case the taxpayer had purchased an accumulative installment certificate under the terms of which

he was to make periodic payments to the seller, who, at the end of ten years, would pay to the taxpayer the sum of $20,000. This $20,000 was approximately $4,900 more than the total amount of the payments made to the seller. The Commissioner contended that this $4,900 was compensation for the use of the taxpayer's money, and was thus really interest. He held that this interest was regular income, although the taxpayer contended it was a capital gain.

The certificate involved in the Caulkins case was in registered form and the decision was based upon an interpretation of Section 117(f) of the Internal Revenue Code of 1939. Section 117(f) provided that amounts received by the holder of registered securities upon their retirement should be considered as amounts received in exchange therefor. The Court held that although the $4,900, at least in many respects, was similar to interest, it was an amount which was received in exchange for the sale of a capital asset and was therefore a capital gain.

To understand the Caulkins decision it is necessary to understand the history of Section 117(f). Before the enactment of that section it had been held that retirement of a bond was not such a sale or exchange as would qualify the amount received upon the retirement for capital gains treatment. See Fairbanks v. United States, 306 U.S. 436, 59 S.Ct. 607, 83 L.Ed. 855 (1939). Section 117(f) was enacted to avoid this holding. It provided that amounts received upon the retirement of certain evidences of indebtedness which had interest coupons attached, or which were in registered form, should be considered as amounts received in exchange therefor. This provision enabled the amounts received upon the retirement of such bonds to qualify as capital gains. The taxpayer contends that this provision was enacted to accord the same tax treatment to such bonds

upon their retirement as always had been accorded them on a sale before retirement. And, according to Mertens Law of Federal Income Tax, Volume 38, page 368, M 82:

> "The purpose underlying the enactment of Section 117(f) of the 1939 Code was to accord to the retirement of obligations similar treatment as was then, and is now, accorded to their sale or exchange."

In view of the purpose of Section 117(f), it appears that before the passage of that section amounts received upon the sale of such evidences of indebtedness did qualify for capital gains treatment. If a sale before maturity of such obligations did not permit increments to be accorded capital gains treatment, it is unlikely that the Congress would have deliberately enacted a provision according them such favorable treatment upon retirement.

From the combination of this legislative history with the Caulkins decision it is possible to draw the following analogy: Section 117(f), under the Caulkins holding, provided that all amounts received in exchange for the retirement of a qualifying capital asset were capital gains. Because Section 117(f) was meant to be declaratory of the pre-existing law on sales before retirement, it follows that all amounts received on the pre-retirement sale of such debt obligations were likewise capital gains. The validity of this analogy must be tested by a further inquiry into legislative, administrative and judicial history. However, before proceeding with that history it is necessary to examine the Government's position as to what the Caulkins case really held.

The Government contends that Caulkins was based solely upon an interpretation of Section 117(f). It says that the crucial fact in Caulkins was not that the debt obligations

were discount obligations but that a retirement rather than a sale was involved. It has thus attempted to convince the Court that the Caulkins decision does not control this case, because in the present instance the notes were sold before maturity, rather than retired. It is true that the opinion in the Caulkins case primarily discusses the retirement factor; however, the Court is not convinced that increments on debt obligations which qualify under Section 117(f) would be accorded capital gains treatment if the obligations were retired, but would be taxed at regular income rates if they were sold before maturity. Even the Tax Court, which adopted that position in Paine v. Commissioner, 23 T.C. 391 (1954), Rev. 236 F.2d 398 (8th Cir., 1956), and Stanton v. Commissioner, 34 T.C. 1 (1960), has now abandoned such a distinction. Gibbons v. Commissioner, 37 T.C. No. 57. The purpose of Section 117(f) surely was not to accord a more favorable tax treatment to income realized upon retirement of debt obligations than it would receive if they were sold before maturity. The quotation from Mertens, supra, also clearly indicates that such was not the case. Therefore, this Court is constrained to hold that the crucial fact in the Caulkins case was that the evidences of indebtedness were discount obligations.

The combination of the Caulkins case with Section 117(f) thus indicates that appreciation realized on evidences of indebtedness, issued at an original discount and sold before maturity, constituted a capital gain and not regular income. The remaining question, therefore, is whether the legislative, administrative and judicial treatments of discount obligations support this indication.

The earliest administrative decision upon this matter which has been furnished to the Court is Office Decision 1024 published in Vol. 2, Cum.Bul. 189 (1920), holding that

original issue discount on bonds was not interest and, therefore, was not subject to special withholding provisions when the bonds were in the hands of foreign corporations. It is true, as the Government contends, that this opinion was not concerned with whether an appreciation resulting from such discount was a capital gain or regular income. It was concerned, however, with whether such gain was in fact interest. The opinion carefully examined the various factors involved and came to the conclusion that original issue discount, while in some ways like interest, differed from interest in other respects and was in fact not interest.

The writers appear to have been agreed that in the period following 1920 a taxpayer could not accrue bond discount, but had to report all of it in the year in which it was received. No part of the discount was allowed to be treated as income prorated over the life of the bond. See Accountant's Handbook, 2d Ed., p. 339 (1932); Newlowe, Intermediate Accounting, p. 205 (1939); and 4 Mertens Law of Federal Income Taxation, Section 23.162, p. 298. However, this well established rule does not meet the real issue in question, which is whether the income, in the year in which it was reported, was treated as a capital gain or as regular income. There is, however, one case from this period which again reiterates the fact that discount is not interest. That case is Corn Exchange Bank v. Commissioner, U. S. Board of Tax Appeals, 6 B.T.A. 158 (1927). Taxpayer had sought to amortize bond discount and premium. The Board of Tax Appeals refused to allow such amortization. In doing so, it said, at page 161:

"The discount on the bond purchased below par is unlike interest, which is a fixed charge and accrues periodically. The right to receive this discount, or difference between

the cost of the bond and its par, cannot be determined in advance as the bond may be sold for more or less than its cost, or, perhaps, as in the case of many bonds, it may be redeemed prior to its maturity at an amount different from its principal or face amount of the bond. This discount is not earned or accrued in annual installments and cannot be income to the holder of the bond, either as additional interest or as a separate item of income."

The Government contends that the Corn Exchange Bank opinion was dealing only with regular discount as distinguished from original issue discount. It fully agrees that discount which is the result of such factors as an obligor's default in interest payments does not give rise to ordinary income. However, an examination of both the facts and the opinion in the Corn Exchange Bank case fails to reveal that the Court there was discussing any particular kind of discount. A practical examination of the transactions involved leads the Court to conclude that it is extremely likely that both kinds of discount were involved.

This case indicates that during the 1920's the Department of Internal Revenue, which prevailed in the Corn Exchange Bank decision, had contended that discount was not interest. And if discount was not interest, income resulting from discount could not have been taxable at regular rates on the premise that it was interest.

In 1940 the Internal Revenue Service held that income realized from the redemption of state discount bonds was interest, and, accordingly, was non-taxable. G.C.M. 21890, 1940–1, Cum.Bul. 85. It said the courts had considered the nature of discount and found it to be like deferred interest. Such discount was, in effect, payment for the use of the money lent. The value of this ruling is questionable, how-

ever, because it necessarily involved statutory and constitutional limitations upon the federal taxation of state bonds. And while the ruling held that such discount was like interest, it carefully avoided holding that it was interest. Thus, at least until 1940, and possibly thereafter, the Internal Revenue Service held that discount was not interest. The legislative treatment of bond discount should be viewed against this administrative background.

In 1929 the Congress authorized the Treasury Department to issue non-interest-bearing discount obligations. The bill authorizing these notes, as passed by the House and as approved by the Senate Finance Committee, contained a provision that, as to profits attributable to the discount, "any gain from the sale or other disposition thereof shall be exempt from all taxation." Congressional Record, Senate, June 4, 1929, p. 2319. This provision for tax exemption met with considerable opposition upon the floor of the Senate, *because the Senators believed such profits were capital gains,* and feared that such a provision would open the way for the future exemption of all capital gains from taxation. Several members of the Senate engaged in a lengthy debate about the relationship between original issue discount and interest, and the tax consequences that flowed therefrom. That debate indicates that at least some members of the Senate believed that original issue discount was in fact a substitute for interest; but those who purported to be familiar with the subject pointed out that, under the then current practice of the Bureau of Internal Revenue, income attributable to original issue discount was treated as a capital gain and not as regular income. See page 2331, Congressional Record, supra. The question was finally resolved by the insertion of a provision in the bill that amounts received as the result of original

issue discount on these notes would be called interest, thus bringing them within the already existing interest exemption Likewise, a similar provision was added as an amendment to the Second Liberty Bond Act of 1917, Title 31 U.S. C.A. § 757c(d). Thus, the legislative history indicates that appreciation resulting from this discount was statutorily transformed into interest to avoid its taxation as a capital gain.

These facts further substantiate the taxpayer's contention that during the period of the 1920's and early 1930's original issue discount was not considered interest, but rather gave rise to a capital gain. Furthermore, the Congress was aware of this construction and acquiesced therein by failing to statutorily change the rule until 1954. See Section 1232(a) (2) (A), Internal Revenue Code of 1954. This section now provides that, upon the sale or exchange of evidences of indebtedness issued by a corporation or a government, amounts of appreciation attributable to original issue discount will not be considered as gains resulting from the sale or exchange of a capital asset. In other words, in 1954, and governing evidences of indebtedness issued after the ones which are now before this Court, the Congress stated that appreciation resulting from original issue discount would henceforth be considered as regular income and not as capital gain.

The House report accompanying this section stated that under existing law such gains were taxed as capital gains if the bond was held to retirement, and that this section was enacted to change that rule insofar as appreciation resulting from original issue discount was concerned. 3 U. S. Code Congressional and Administrative News, 1954, p. 4110. The report of the Senate Finance Committee is less helpful. It merely stated that "There is some uncer-

tainty as to the status of proceeds in these transactions, i. e., as capital gain or as interest income where the bond or other evidence of indebtedness has been issued at a discount * * *." 3 U. S. Code Congressional and Administrative News, 1954, p. 4745. In support of its statement that there was some confusion as to the current status of the law, the Senate report compared Commissioner v. Caulkins to I.T. 3486, 1941-2 Cum.Bul., p. 76. However, the Internal Revenue holding, upon which the Senate Committee relied, dealt only with a specific statutory provision which provided that such gains realized on the sale of Treasury bills should be interest. That provision had been enacted to make such gains non-taxable by bringing them within the exemption which interest enjoyed. Thus, the Senate Report does not cite any evidence of uncertainty insofar as the generally applicable principles are concerned.

At various times the Congress has enacted special provisions regarding the treatment of discount. For instance, the Internal Revenue Code of 1939, Sections 201(e) and 207(e), provided that stock and mutual life insurance companies must accrue discount.

And in 1938 the House Ways and Means Committee discussed the relationship between discount and interest. That Committee report stated:

> "It is important also to emphasize that there is no clear separation, in practice, between capital gains and ordinary income; * * * *A bond purchased at a premium results in a capital loss when redeemed at par, and a bond purchased at a discount, in a capital gain.*" Hearings on H.R. 9682, Subcommittee of Committee on Ways and Means, 75th Congress, Third Session, p. 38. (Emphasis added.)

Here again is evidence of Congressional knowledge that appreciation due to bond discount was a capital gain. The Subcommittee recommended that no change be made in this rule.

And again, in Section 42(b) of the 1939 Internal Revenue Code, the Congress gave taxpayers an election to treat as current income the periodic increases in redemption value of non-interest-bearing obligations issued at a discount when such obligations were redeemable for fixed amounts which increased at stated intervals.

Thus the evidence indicates that the Congress clearly believed that appreciation resulting from original issue discount was a capital gain. With this knowledge Congress adopted various pieces of specific legislation providing for special treatment of discount in certain specified situations. However, Congress took no action to change the general law. These facts indicate a Congressional intention, until 1954, that capital gains treatment continue to be accorded to gains resulting from bond discount. And there was no indication of any thought that different treatment should be given to gains resulting from original issue discount than was accorded those resulting from other types of discount.

Both parties have cited various explanations and public policies underlying the special treatment which the Congress has accorded to capital gains. As the Government has indicated, there are several reasons for this special treatment. However, even the Government cannot deny that one important reason is to avoid taxing, at unusually high rates, income which has in fact been earned over a number of years but which is realized only in the year of sale. In other words, the accumulation of income actually accrued over a period of years, but realized only in the year of sale, which is inherent in the profitable sale of most capital as-

sets, would, under our system of highly progressive income taxation, result in a taxation of such income at far higher rates than would have been the case if the income had been reportable in each of the years in which it accrued but was not realized. The capital gains provisions place a limit upon the extent to which such gains can be taxed. In view of this purpose, it certainly appears that the long-term appreciation, resulting from original issue discount of bonds and other evidences of indebtedness, can be appropriately fitted within that category of appreciation which is accorded the special capital gains treatment.

In several instances the Tax Court has had occasion to consider the proper method of taxing gains resulting from original issue discount. It must be remembered that in the Corn Exchange Bank case, supra, the Board of Tax Appeals held that discount was not interest. The next occasion on which the Court was faced with the problem was in Caulkins v. Commissioner, 1 T.C. 656 (1943), where it decided that original issue discount gave rise to a capital gain and not to regular income. It was this opinion which was affirmed by the Sixth Circuit in Commissioner v. Caulkins, supra.

In 1954, on a complex factual situation, it held that discount was really interest and therefore gave rise to regular income when the securities were sold before maturity. Paine v. Commissioner, 23 T.C. 391 (1954). That holding was reversed by the Eighth Circuit in Paine v. Commissioner, 236 F.2d 398 (1956). While it cannot be said that the Eighth Circuit held that discount resulted in a capital gain, that Court did hold that the appreciation involved in the Paine case was not interest. The language of the Court further indicates, however, that it did not think that

discount created gains which were taxable as regular income.

Another case before the Court was Commissioner v. Morgan, 30 T.C. 881 (1958), involving accumulative investment certificates identical to those in the Caulkins case. The Tax Court held that the appreciation on these certificates was a capital gain. The Commissioner appealed that determination to the Ninth Circuit, which reversed the Tax Court. Commissioner v. Morgan, 272 F.2d 936 (1959). The Court of Appeals considered the Sixth Circuit's Caulkins decision and refused to follow it. The Court held that Section 117(f) was designed only to allow capital gains treatment to be accorded to "true" capital gains. The Court refused to give the language of Section 117(f) the all-encompassing scope that it had been accorded by the Sixth Circuit.

The Tax Court reaffirmed its holding that such gains were capital gains in Goodstein v. Commissioner, 30 T.C. 1178 (1958). And it was again faced with another of the Caulkins-type accumulative investment certificates in Kormendy v. Commissioner, 18 T.C.M. 353 (1959). This case was decided after Morgan but before the reversal of Morgan by the Ninth Circuit. Again, the Tax Court affirmed its Morgan and Caulkins holdings.

Finally, in 1960, after the reversal of the Morgan decision by the Court of Appeals, the Tax Court again had a similar problem in Stanton v. Commissioner, 34 T.C. 1 (1960). In that case the taxpayer had purchased short-term Government notes and commercial paper at a discount. This paper he sold before maturity but after holding for more than six months. The excess of the amount realized over the cost was reported as a long-term capital gain. The Tax Court held that the appreciation was regular income

because the notes were sold before maturity. In support of this decision the Court cited its Paine opinion, which it said had been reversed on other grounds.

The most recent case that it has considered was Gibbons v. Commisioner, 37 T.C. No. 57. In Gibbons the Tax Court held that discount was *always* interest, and thus regular income, no matter whether it was realized upon a sale or exchange before retirement, or upon the retirement of a debt obligation. Thus, in Gibbons, the Tax Court completely rejected the Caulkins decision, and abandoned the distinction that it had made in Paine and Stanton between gains realized on a sale and gains realized on a retirement.

The problem of original issue discount has been considered recently by a number of constitutional courts. Most of the decisions which were cited to this Court have but again reaffirmed the validity of the general principle for which the Government contends. When the evidences of indebtedness in question were interest-bearing obligations the applicability of this proposition cannot be questioned. Cases which have dealt with the rule in such situations are: Fisher v. Commissioner, 209 F.2d 513 (6th Cir., 1954), cert. den. 347 U.S. 1014, 74 S.Ct. 868, 98 L.Ed. 1136; United States v. Langston, 308 F.2d 729 (5th Cir., 1962); Arnfeld v. United States, 163 F.Supp. 865, 143 Ct.Cl. 277 (1958), cert. den. 359 U.S. 943, 79 S.Ct. 722, 3 L.Ed.2d 676; and Jaglom v. Commissioner, 303 F.2d 847 (2d Cir., 1962); cf. Commissioner v. Phillips, 275 F.2d 33 (4th Cir., 1960). Thus, there are only five cases which actually have dealt with the treatment to be accorded to gains resulting from original issue discount. Those cases are: Commissioner v. Caulkins, 144 F.2d 482 (6th Cir., 1944); Commissioner v. Morgan, 272 F.2d 936 (9th Cir., 1959); Rosen v. United

States, 288 F.2d 658 (3d Cir., 1961); United States v. Harrison, 304 F.2d 835 (5th Cir., 1962); and Pattiz v. United States, Ct.Cl., 311 F.2d 947 (1963). The Morgan and Rosen decisions were based upon the same fact situation that was presented to the Sixth Circuit in Caulkins. The results in the Third and Ninth Circuits were obtained by a specific rejection of the Caulkins decision. In neither case did the Court examine the legislative, administrative or judicial history which has surrounded the treatment of original issue discount. Instead, the Court was presented with the proposition on an almost *de novo* basis and, perhaps naturally enough in the absence of familiarity with the detailed history, fell back upon the broad, general proposition for which the Government here contends. Likewise, the Harrison and Pattiz decisions were based upon a specific reject' of Caulkins and on an adoption of the Morgan and Rosen opinions, and neither case considered the historical treatment of original issue discount. Therefore, while it is true that the recent cases have adopted the Government's position, they have done so (1) without a discussion of the h'storical treatment of gains resulting from original issue discount, and (2) only upon a rejection of the Caulkins case, which is controlling in this Circuit.

The following factors support the taxpayer's contention: (1) the opinions of the Department of Internal Revenue and the Board of Tax Appeals, during the 1920's and early 1930's that discount was not interest; (2) Congressional belief, expressed both in 1929 upon authorization of Treasury bills and later in the Second Liberty Bond Act, that original issue discount resulted in a capital gain, and consequent Congressional action to avoid that result; (3) the report of the Subcommittee of the Ways and Means Committee of the House of Representatives, in 1938, that dis-

count gave rise to a capital gain; (4) Congressional enactment of various specific pieces of legislation providing that appreciation resulting from discount would be treated as other than a capital gain; (5) the failure of the Congress to take any action to change the treatment of bond discount except in regard to highly specialized factual situations, (6) the passage of Section 117(f), as interpreted by the Caulkins decisions, indicating that all amounts received upon retirement, and attributable to original issue discount, were capital gains; (7) the numerous early opinions of the Tax Court that original issue discount resulted in a capital gain; and (8) the fact that none of the cases which have rejected Caulkins have considered the historical treatment of bond discount. Against these factors, and in support of the Government's contention, it is possible to infer, from several administrative rulings dealing with specific statutory situations, that bond discount was really interest and was taxable as regular income. The 1929 Senate debate and the 1938 House hearings refute any possible implication from other Congressional enactments that original issue discount resulted in regular income. The factors supporting the taxpayer's contention are clearly of controlling weight.

It may well be that, in financial circles at least, original issue discount is considered to be a form of interest. If this is the case, it is certainly understandable why the various courts of appeal, which have considered this question on an almost *de novo* basis, have held that original issue discount resulted in regular income to the taxpayer. It is likewise true that there has been a trend—commencing with certain legislative enactments, proceeding through some administrative interpretations, and culminating with the Congressional enactment of 1954—toward classifying ap-

preciation resulting from original issue discount as interest. This trend began with certain very specific factual situations and expanded to include nearly all governmental and corporate evidences of indebtedness. However, careful study of this developing trend confirms the Court's belief that it has effectuated a change in the law. The facts in this case are not within any of the specific factual situations for which this change has been made and, therefore, the Court is constrained to hold that, as to the notes here in question, the appreciation for taxation purposes was not interest but, rather, an appreciation on capital, and was therefore taxable as a capital gain.

Should it be required, this memorandum will be adopted as findings of fact and conclusions of law under Section 52(a), Federal Rules of Civil Procedure.

[335 F. (2d) 209 (2d Cir., 1964).]

Joseph I. LUBIN and Evelyn J. Lubin, and Estate of Joseph Eisner, Deceased, Helen Eisner, Executrix, and Helen Eisner, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Nos. 445, 446, Dockets 28804, 28805.

United States Court of Appeals
Second Circuit.
Argued May 7, 1964.
Decided July 27, 1964.

Before WATERMAN and FRIENDLY, Circuit Judges, and ANDERSON, District Judge.

Appendix C—Conflicting Opinions

WATERMAN, Circuit Judge:

We are called upon in this case to determine whether a sum of $1,000,000 realized by four taxpayers upon the retirement of twelve registered mortgage notes, a sum representing the difference between the $3,000,000 face value of the notes and the $2,000,000 which the taxpayers actually paid for them upon issuance, is to be treated for income tax purposes as ordinary income or as a capital gain. The Tax Court, T. C. Memo 1963-292, concluded that the $1,000,000 increment represents interest realized by the taxpayers upon a principal sum, and therefore has ruled that ordinary income treatment is proper and that the Commissioner's assertion of deficiencies totaling $789,161.21 should be upheld. As we are of the opinion that the taxpayers should have been accorded capital gains treatment on the increment here involved, we reverse the Tax Court.

The petitioner-taxpayers are two couples, Joseph Lubin and wife and Samuel Eisner and wife, each of whom filed joint income tax returns for the calendar year 1954.[1] At the time the transactions relevant to this appeal arose, Messrs. Lubin and Eisner were the senior partners in a New York accounting firm. In March of 1953 Lubin was approached by a broker who advised him that the stock of Sattlers, Inc., the largest department store in Buffalo, New York, and the stock of Brighton Products, Inc., the corporation which operated the store's meat department, were being offered for sale for a total price of $6,500,000. Lubin analyzed assorted financial data concerning the two corporations in question, and as a result he happily con-

1. Eisner died on May 4, 1958, and his estate was made a party to these proceedings. His wife, as executrix, is therefore a party not only as a taxpayer, herself, against whom a deficiency has been asserted, but also as her deceased husband's executrix.

cluded that not only did the corporations have a net worth of more than $8,100,000 exclusive of good will, but also that they had been generating an annual earned income after taxes of about $700,000. This spelled out an easy and almost certain profit of more than $2,000,000 for the fortunate person or persons who would purchase the stock at the price then being asked. Lubin therefore informed the broker that he and the other taxpayers were desirous of going ahead with the purchase, they intending at that time to buy the stock, operate the department store corporations for about a year, and then sell the stock at a profit that would net them a long term capital gain.

The broker then revealed to Lubin that he was acting on behalf of a Buffalo businessman named Irving Levick who had discovered the attractive opportunity, and who, according to the broker, would have to be included among those taking advantage of it. A meeting was arranged between Lubin and Levick, at which Levick disclosed that, although he could arrange institutional financing in the amount of $4,500,000 on the strength of the assets of the two corporations to be purchased, he, Levick, did not have the additional $2,000,000 necessary to close the deal. Lubin then proposed that he and his fellow taxpayers participate in the venture and furnish the needed cash in return for a half share in the anticipated $2,000,000 profit; Levick agreed. A discussion followed as to the form the proposed transaction was to take, and Lubin made it clear to Levick that, as the Lubins and Eisners were all in very high income tax brackets, the gain to be realized by them on the deal would have to be taxable at capital gains rates. Levick rejected, however, Lubin's suggestion that he and his associates buy all of the stock and sell it to Levick at the end of the capital gains period, Levick giving as his reason

his desire to own all of the stock and hold himself out as proprietor of the companies involved from the very beginning of the venture. Lubin asserted that the petitioners were willing to cede such control to Levick at the outset as long as a capital gains tax rate could be assured for them, and, after the two negotiators agreed to formulate a plan whereby petitioners could realize a profit of $1,000,000 taxable at the desired rate, Lubin set out to investigate what sort of plan might serve this purpose.

Toward this end Lubin sought the advice of the partner in his accounting firm who was in charge of the firm's tax department, and he, relying on the decision in Commissioner v. Caulkins, 144 F.2d 482 (6 Cir. 1944), and the Commissioner's reported acquiescence in it, advised Lubin that the desired profit and capital gains treatment could be assured through the use of registered notes bearing a face value of $1,000,000 greater than the amount the taxpayers were to advance. Relying upon this advice, and upon his own reading of the authorities cited to him by his partner, Lubin decided to go ahead with the venture on this basis. Accordingly, Lubin and Levick quickly set into operation a series of arrangements designed to carry out the plan. A corporation owned by Levick and his associates named Seneca Warehouse & Industrial Center, Inc. (hereinafter Seneca), organized a wholly owned subsidiary, Associated Investors, Inc., for the purpose of acquiring the stock of the sought-for department store corporations. The petitioners then advanced $2,000,000 to Seneca, Seneca made this amount available to Associated Investors, Inc., and Associated Investors, Inc. combined this money with $4,500,000 it had raised through institutional financing and purchased the stock of the Buffalo department store corporations. In consideration for their advance of the $2,-

000 000 Lubin and the other petitioners received from Seneca twelve registered mortgage notes having face amounts of $250,000 each, totaling in full $3,000,000 and dated June 29, 1953.[2] The face amount of each note was payable as follows: $187,500 on January 4, 1954, or a little more than six months after issuance, and $5,208.33 on the fourth day of each month thereafter until January 4, 1955. The notes by their terms also provided for payment of interest at the rate of two per cent per annum on face value. Sometime after January 4, 1954 all of the notes were paid off in full, together with an additional sum of $4,458.25 that was paid on each note representing the agreed-upon two per cent interest charge, and the petitioners all reported as ordinary income on their 1954 federal returns the amounts so received by them as such interest. The petitioners all reported as long term capital gains, however, the amounts received in payment of the face value of each note which exceeded the sum the petitioners originally advanced to the obligor, an excess which, combined for all of them, was exactly $1,000,000. The Commissioner, alleging that these increments were taxable as ordinary income as to each of the taxpayers, asserted deficiencies against them for the calendar year 1954. The Tax Court sustained the Commissioner. That Court ruled that the $1,000,000 realized by the petitioning taxpayers through the above described transaction was but interest paid the taxpayers by Seneca for the use of the $2,000,000 which had been utilized in purchasing the stock of the two department stores. On this appeal, the taxpayers argue that the Tax Court erred in characterizing the amount in

2. Four notes were issued to Lubin and four were issued to his wife; two notes were issued to Eisner, and two were issued to his wife.

controversy as interest, and that capital gains treatment is therefore called for under Section 1232(a) (1) of the 1954 Code; as an alternative argument taxpayers claim that the Commissioner is foreclosed from asserting the alleged deficiencies against them because of his acquiescence in Commissioner v. Caulkins, supra, which was of record at the time the taxpayers entered into the transactions which gave rise to the controversy. We need not discuss taxpayers' latter argument (though we do note that this court's recent decision in Dixon v. United States, 333 F.2d 1016 (2 Cir. 1964), relying on Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 183, 77 S.Ct. 707, 709, 1 L.Ed.2d 746 (1957), is very strong authority for rejecting it) for we agree with taxpayers that, apart from any reliance they may have placed upon the Caulkins decision, they are entitled to capital gains treatment under Section 1232(a) (1) of the 1954 Code.

[1] Section 1232(a) (1), which controls as to the gain here involved, provides that, in the case of bonds or other evidences of indebtedness which are capital assets in the hands of a taxpayer, "[a]mounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954)."[3] Language identical in all material respects with

3. Section 1232(a) (2) of the 1954 Code now clearly provides that a gain such as the one realized by these taxpayers is to be taxed as ordinary income. Section 1232(a) (2) applies, however, only to bonds or other evidences of indebtedness issued after December 31, 1954, and the notes we are concerned with here were issued one and one-half years before that date, on June 29, 1953.

that used in Section 1232(a) (1) was considered in the 1944 case of Commissioner v. Caulkins, supra, and the court in that case interpreted Section 117(f) of the 1939 Code, the forerunner of Section 1232(a) (1), so as to require capital gains treatment as a matter of law for all amounts received upon the redemption of a bond. The Caulkins decision stood as authority for a number of years, but recent consideration of the problem presented in that case, primarily in the light of an examination of the legislative history of Section 117(f) of the 1939 Code, has led to its express rejection by four Courts of Appeals, including our own. Dixon v. United States, supra; United States v. Harrison, 304 F.2d 835 (5 Cir. 1962), cert. denied, 372 U.S. 934, 83 S.Ct. 881, 9 L.Ed.2d 765 (1963); Rosen v. United States, 288 F.2d 658 (3 Cir. 1961); Commissioner v. Morgan, 272 F.2d 936 (9 Cir. 1959). See also Jaglom v. Commissioner, 303 F.2d 847 (2 Cir. 1962), where this Court held that the portion of the sales price of bonds which represented unpaid interest that had accrued on them prior to sale was to be taxed as ordinary income. We regard these cases as clear authority for the proposition that Caulkins was erroneously decided and ought now to be regarded as dead and buried, but we cannot agree with the Commissioner, who relies upon them, that these cases require us to rule with the Tax Court that the amount in controversy here must be taxed as ordinary income. As we read the Dixon, Mason, Rosen, and Harrison decisions, they lay down the very sound rule that, despite a contrary inference which might be drawn from too literal a reading of the language of Section 1232(a) (1), taxation at ordinary income rates is proper where a sum paid upon the retirement of a bond or note in fact represents interest for the use of the money represented by the principal of the cer-

tificates of indebtedness. Unlike the situations which obtained in the cited cases where the increments representing an excess of face value over original cost were relatively small, increased regularly year by year, and were clearly interest equivalents,[4] in the situation before us the extra amounts received upon retirement of the registered notes did not represent interest but represented the note holders' share in profits realized through the purchase of undervalued stock.

[2, 3] In determining how to characterize the gain in this case, the statement from Deputy v. Du Pont, 308 U.S. 488, 498, 60 S.Ct. 363, 368, 84 L.Ed. 416 (1940), that "interest on indebtedness means compensation for the use or forbearance of money," while useful as a starting point, is not dispositive of the issue before us, nor can it be. The Commissioner would have us rule that anything above face value paid on notes by an obligor must, as a matter of law, be regarded as interest, no matter what the substance might be of the underlying transaction which has given rise to the obligations. Of course this approach runs directly counter to the admonition laid down in Old Colony R. R. Co. v. Commissioner, 284 U.S. 552, 561, 52 S.Ct. 211, 214, 76 L.Ed. 484 (1932), and later adopted in Deputy v. Du Pont, supra, itself, 308 U.S. at 498, 60 S.Ct. at 368, that

4. Under the terms of the notes in the case at bar, three-quarters of the face value was payable in just over six months and the remaining one-quarter was payable in equal monthly payments over the course of the next twelve months. Since the face value of the notes exceeded their cost by 50%, if the excess of face value over original cost were to be considered as interest, the "interest" charge would figure out to be well in excess of 75% per year and this rate would be charged for money used to consummate a deal where all parties agreed that there was almost no risk at all involved.

the term "interest" when used by Congress is to be construed according to "the usual, ordinary, and everyday meaning of the term" and not according to "some esoteric concept derived from subtle and theoretic analysis." As this Court stated in Dixon v. United States, supra, 333 at 1016, after having completed an analysis purposed toward reducing the transactions underlying the obligations there involved "to their essentials": "It would seem arbitrary to insist, as do the taxpayers, that significant tax consequences should hinge upon whether this * * * sum is separately stated as interest or is included in the face amount of the note. It has been repeatedly emphasized that our taxing statutes are intended to take cognizance of realities and not mere appearances or facades." In the present case it would seem that the Commissioner arbitrarily has refused to take cognizance of the realities of the transaction, and we think it reasonable that what was said in Dixon should apply to the Commissioner with the same force as to taxpayers.

[4] Of course, when reduced to their essentials, the transactions which gave rise to the issuance of these notes did not comprehend that the increment of $1,000,000 was interest for the use by the obligor of petitioners' money. It is undeniable that the petitioners' business venture was predicated from the very start upon their right to share, on an equal basis with the Buffalo businessman Levick, a proposed $2,000,000 profit to be derived from the purchase of stock which was being undervalued by the seller. Their original plan, once they learned of the need for Levick's participation, was to acquire the stock with a contract to sell it to Levick or the corporation at a profit of $1,000,000 after the passage of sufficient time to assure them of capital gains treatment. The substance of the transaction is not

changed simply because they cast the deal in the form of registered notes in order to accommodate Levick who desired to be known from the time of original purchase as the owner. As the Code does not require a profit realized in this form to be treated as interest, and as the evidence relating to the substance of the transaction afforded n basis upon which the Tax Court could have concluded that these profits were interest payments, we hold that § 1232(a) (1) should be applied in accordance with its terms so that petitioners will be taxed at capital gains rates.

Reversed.